STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
SAN FRANCISCO

In the Matter of: AUTOMOTIVE FUNDING GROUP, INC. dba COUNTY FINANCIAL SERVICES, COREY E. LEYTON, and MITCH C. LEYTON, Respondents.	File No. OC-150A OAH No. L 2001040538 DECISION AND ORDER

DECISION

This matter was heard before Administrative Law Judge Jonathan Lew, State of California, Office of Administrative Hearings, on July 23, 2001, in Los Angeles, California.

The Department of Insurance was represented by James Stanton Bair III, Staff Counsel, Auto Compliance Bureau, Legal Division, Department of Insurance.

Respondents Automotive Funding Group, Inc., dba County Financial Services, Corey E. Leyton and Mitch C. Leyton were represented by Robert W. Hogeboom, Esq. and Robert J. Cerny, Esq., Barger & Wolen LLP, 515 South Flower Street, 34th Floor, Los Angeles, California 90071.

Submission of the matter was deferred pending receipt of closing briefs. Opening briefs were received on August 24, 2001, and marked as Exhibits 2 and A for the Department and Respondents, respectively. Reply briefs were received on September 28, 2001, and marked as Exhibits 3 and B. The case was thereafter submitted for decision.

The Administrative Law Judge submitted his proposed decision dated November 9, 2001, and officially filed as a public record on November 29, 2001, which recommended its adoption as the decision of the Insurance Commissioner. The Commissioner considered but did not adopt the proposed decision, and gave written notice of his rejection on February 19, 2002. The notice gave Respondents an opportunity to submit written argument to the Commissioner why the proposed decision should be adopted.

Written argument was submitted by Respondents dated May 13, 2002, and was received by the Commissioner on May 15, 2002.

NOW, THEREFORE, having considered the entire record including the evidence introduced in the proceedings held in this matter, and Respondents' Statement Re Proposed Decision, the Insurance Commissioner hereby makes the following Findings of Fact, Determinations of Issues, and Order

FACTUAL FINDINGS

Identity of Respondents

1. AFG is a California corporation licensed by the California Department of Corporations (DOC) under corporation number C1701419 to conduct business in California.

2. AFG's primary business is consumer finance lending for used automobiles. AFG purchases and assumes the financing responsibilities for installment sales contracts for used automobiles from automobile dealers in California.

3. At all relevant times, Mitch Leyton has been chief executive officer of AFG and has held a California resident fire and casualty broker agent license from the California Insurance Commissioner (Commissioner) originally issued on April 4, 1985.

4. At all relevant times, Corey Leyton has been the president of AFG and has held a California resident fire and casualty broker agent license originally issued April 4, 1985.

5. AFG, or its corporate predecessor, has been conducting consumer finance lending in California since approximately 1963.

6. AFG is financially stable and is regulated by the DOC as a finance lender under License No. 6031095. In that regard, AFG must submit to the DOC annual audited financial statements pursuant to California Financial Code section 22159. AFG is also subject to examination by the DOC pursuant to California Financial Code section 22701.

AFG's Consumer Finance Lending Business

7. AFG is in the business of providing consumer finance loans to purchasers of used automobiles. AFG's target customers have low credit ratings and are considered

high risk or unacceptable by standard lenders. AFG's customers typically purchase vehicles of low value.

8. In the used automobile sales business, dealers often enter into installment sales contracts with customers under which the dealer agrees to finance the purchase of a used automobile at an agreed upon price and interest rate.

9. AFG makes arrangements with used car dealers to purchase these installment sales contracts from the dealers where the customer/borrower has a low credit rating and would not be accepted by other standard lenders. The installment sales contracts are effected on a preprinted form. The installment sales contract provides that in consideration for the loan, AFG retains a security interest in the vehicle up to the amount of the loan.

10. AFG presently has such arrangements with approximately 50 dealers in California and in 2000 financed approximately 4,700 used automobile purchases.

11. In many cases, AFG is the only lender willing to finance an automobile purchase for its high risk customers.

12. After AFG purchases an installment sales contract from the dealer, the customer makes monthly payments to AFG. Most of AFG's purchases of installment sales contracts occur soon after the original purchase of the car.

13. Sixty-one percent of AFG's installment sales contracts have a term of three years or less. Ninety-one percent of automobiles financed have a value of less than $10,000.

<u>The Loss Damage Waiver</u>

14. The AFG installment sales contract requires the customer to show proof of automobile physical damage and collision insurance coverage that would indemnify AFG for the amount financed in the event that the vehicle is damaged or stolen.[1]

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[1] Where the customer does not have physical damage and collision insurance coverage, the installment sales contract states:

> "If you do not have this (physical damage and collision) insurance, we may, if we choose, buy physical damage insurance. If we decide to buy physical damage insurance, we may either buy insurance that covers your interest and our interest in the vehicle, or buy insurance that covers only our interest. If we buy either type of insurance, we will tell you which type and the charge you must pay. The charge will be the premium for the insurance and a finance charge at the Annual Percentage Rate shown on the front of this contract. If the vehicle is lost or damaged, you agree that we may use any insurance settlement to reduce what you owe or repair the vehicle."(parenthesis added)

15. As an alternative to proof of physical damage and collision insurance coverage, AFG offers a "Damage Repair Program Loss Damage Waiver" (LDW, Attachment A to this decision). In order for AFG to finance the customer's purchase, the customer must either provide proof of liability insurance or enroll in the LDW program.[2]

16. Under the LDW, AFG agrees to forgive the balance of the borrower's debt if the vehicle that secures the loan is declared a total loss due to collision or theft. The LDW also provides that if the automobile is damaged but not a total loss, AFG may choose to repair it. As the financed vehicles are generally of low value, approximately 80 percent of reported collisions or thefts of vehicles covered under the LDW program result in total losses because the cost to repair the vehicle would exceed its value. Under the LDW, AFG has the sole discretion to declare a vehicle a total loss.

17. The LDW form prominently discloses that it is not a contract of insurance. Rather, it states that upon enrollment, the lender (AFG) "agrees to shift the risk of loss from the Borrower to Lender" of damage to the vehicle, subject to specified conditions.

18. The first condition is that the borrower agrees to notify AFG whenever damage to a vehicle exceeds $500. Second, if damage does occur, then AFG will determine whether the vehicle is repairable or a total loss. If the vehicle is repairable, AFG will repair it above the first $500 and after the borrower has paid specified costs and fees. If the vehicle is a total loss, then the outstanding installment contract balance is deemed satisfied less $500 and specified fees and costs.[3] The LDW provides that AFG reserves the right to retain the damaged vehicle.

19. The borrower generally pays for the LDW in monthly installments corresponding to the installment payments for the loan. If the borrower fails to pay, the LDW terminates 20 days after the installment payment due date. According to a price chart issued to dealers by AFG, the cost of LDW to the borrower ranges from $100 to $6,480 depending on the amount financed and the term of the loan. The average cost of the LDW is approximately $1,300 over a two-year term or $55.00 per month. In determining the cost to borrower, the automobile dealer adds the LDW fee to the total price of the vehicle, which is used as a basis for computing the amount financed. A borrower enrolling in the LDW program must agree to a minimum term of 30 days. A $100 nonrefundable documentation fee is normally charged. If the borrower obtains

[2] This stipulation is at odds with stipulation 12 above, which states that "Most of AFG's purchases of installment sales contracts occur soon after the original purchase of the car" (underline added). The stipulation begs the question of why the customer would agree to anything after the purchase was completed since no sale would take place without there first being an arrangement for financing of the purchase price. It would appear, therefore that purchase and financing takes place at time of sale. This conclusion is supported by stipulation 14.

[3] The LDW provides that in a total loss occurrence the outstanding loan contract balance due lender from the borrower "shall be deemed satisfied, except for … the first $500.00 in damages per loss occurrence…" This raises the question of whether the contract is truly a debt cancellation agreement as Respondents contend. Presumably, where the borrower fails or to pay this $500.00 fee the debt is not cancelled.

insurance coverage on the vehicle from a California admitted insurer, the LDW will terminate when AFG obtains proof of coverage. The monthly payment for the LDW then ceases.

20. Obligations of AFG and the borrower under the LDW expire when the amount financed under the installment sales contract has been paid in full.

21. The LDW provides that AFG has complete control and discretion of whether a given vehicle is repaired or declared a total loss and also has control over where a vehicle is repaired. As of July 2001 there were approximately 2,300 LDWs in force in California.

22. AFG accepts all payments for participants in the program, secures licensed adjusters to evaluate claims and pays the costs of repairs to contracted body shops. Under the LDW, AFG does not make any cash payments to borrowers. Rather, the vehicle is either repaired or the borrower's debt is extinguished, provided the borrower first pays the $500.00 fee. See footnote 1.

23. AFG makes arrangements for the dispositions of totally destroyed vehicles at its discretion.

24. Neither the DOC nor the Department has received any complaints from borrowers that AFG has failed to perform its duties under the LDW.

Order to Show Cause

25. In approximately July of 2000, the Department informed AFG that it was transacting insurance in violation of Insurance Code section 700. On April 25, 2001, the Department issued an Order to Show Cause requiring AFG to show why the Department should not issue a cease and desist order prohibiting AFG from issuing the LDW. The Department believes that AFG is transacting insurance in violation of Insurance Code section 700.

26. AFG believes that the LDW is a debt cancellation contract incidental to AFG's business of making loans secured by automobiles and therefore, that the LDW is not insurance and is outside the jurisdiction of the Department.

DISCUSSION

The issue is whether the LDW contract constitutes transacting the business of insurance within the regulatory jurisdiction of the Insurance Commissioner.

Insurance Defined

The Legislature has defined insurance as "a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event." (Ins. Code, § 22.) It necessarily involves two elements: (1) a risk of loss to which one party is subject and a shifting of that risk to another party; and (2) distribution of risk among similarly situated persons. (*Metropolitan Life Ins. Co.* v. *State Bd. of Equalization* (1982) 32 Cal.3d 649, 654.) It involves a contract based upon consideration to compensate the insured for loss sustained upon the occurrence of some contingency, usually in the form of the payment of a designated sum of money.[4]

Principal Object or Ancillary Test

Insurance laws regulating the business of insurance are not intended to apply to all organizations having some element of risk assumption or distribution in their operations. When the insuring element is not the basis of the bargain and is incidental to the principal object of the transaction California courts generally find that the transaction does not constitute insurance. (*California Physicians' Service* v. *Garrison* (1946) 28 Cal.2d 790; *Transportation Guar. Co.* v. *Jellins* (1946) 29 Cal.2d 242; *Truta* v. *Avis Rent A Car System* (1987) 193 Cal.App.3d 802.) Thus, the determination of whether the LDW contract is one of insurance necessarily focuses upon whether risk transference and risk distribution are the principal object and purpose of the transaction. (*Truta* v. *Avis Rent A Car System, Inc*., *supra*, 193 Cal.App.3d at p. 813.)

In *Truta*, the court considered an option in car rental agreements under which the rental company would assume the risk of physical damage to the car up to $1,000 for a $6.00 daily fee. It found that the principal object and purpose of the transaction before it, the element that gave the transaction its distinctive character, was the rental of an automobile. The option was only peripheral to that primary object, available to the lessee for additional consideration. After reviewing the entire contract the court was satisfied "that this tangential risk allocation provision should not have the effect of converting the defendants as contracting lessors into insurers subject to statutory regulation." (*Truta* v. *Avis Rent A Car System, Inc.*, *supra*, 193 Cal.App.3d at p. 814.)

[4] Under the traditional test adopted by courts an insurance contract has the following five elements:

(a) The insured possesses an interest of some kind susceptible to pecuniary estimation, and known as an insurable interest;
(b) The insured is subject to a risk of loss through the destruction or impairment of the insurable interest by the happening of certain designated fortuitous perils [the insured event];
(c) The insurer assumes that risk of loss [risk transference];
(d) The insurer assumes that risk as part of a general scheme to distribute the actual losses among a large group bearing somewhat similar risks; and
(e) As consideration for the insurer's promise to assume the risk of loss, the insured makes a contribution (premium) to the general insurance fund.

(See generally, Holmes's Appleman on Insurance, 2d (1996) section 1.4(A).)

The *Truta* court explained:

> "A statute designed to regulate the business of insurance … is not intended to apply to all organizations having some element of risk assumption or distribution in their operations. The question of whether an arrangement is one of insurance may turn, not on whether a risk is involved or assumed, but on whether that or something else to which it is related in the particular plan is its principal object and purpose." (12 Appleman, Insurance Law and Practice (1981) § 7002, p. 14, fns. omitted.) This is because "insurance regulatory laws are not properly construed as aimed at an absolute prohibition against the inclusion of any risk-transferring-and distributing provisions in contracts for services or for the sale or rental of goods. In short, the presence of a <u>small element</u> of insurance, if one wishes to call it that, closely associated with the predominant element of the transaction—the element that gives the transaction its distinctive character—does not conclusively demonstrate that the transaction is within the reach of insurance regulatory laws." (Keeton, Insurance Law (1971) § 8.2(c), p. 552.) (Underline added)

(*Truta* v. *Avis Rent A Car System, Inc.*, *supra*, 193 Cal.App.3d at p. 812.)

This analytical approach consistently has been utilized in California. In *California Physicians' Service* v. *Garrison*, *supra*, 28 Cal.2d 790, professional medical services were rendered to low-income patients who paid monthly membership dues to a nonprofit corporation and payment for these services was made through a fund created by the dues received by the nonprofit corporation. In holding that the Service was not engaged in the insurance business the Supreme Court noted that absence or presence of assumption of risk or peril is not the sole test to be applied. "The question, more broadly, is whether, looking at the <u>plan of operation as a whole</u>, 'service' rather than 'indemnity' is its principal object and purpose." (*California Physicians' Service* v. *Garrison*, *supra*, 28 Cal.2d at p. 809.) (underline added)

Similarly, in *Transportation Guar. Co.* v. *Jellins*, *supra*, 29 Cal.2d 242, the court considered whether two truck maintenance contracts containing provisions that the contractor agreed to insure the vehicles for the owner in an authorized insurance company constituted insurance contracts. The court observed: "that an incidental element of risk distribution or assumption may be present should not outweigh all other factors. If attention is focused <u>only on that feature</u>, the line between insurance or indemnity and other types of legal arrangement and economic function becomes faint, if not extinct." (*Id*. at p. 249.) (underline added) The court noted that it was obvious that it was not the purpose of the insurance statutes to regulate all arrangements for assumption or distribution of risk and that "[t]he question turns, not on whether risk is involved or assumed, but on whether that or something else to which it is related in the particular plan is its principal object and purpose." (*Ibid*.)(underline added)

LDW as Insurance

The Department contends, in effect, that the LDW's debt cancellation *and* repair contract plan provisions, as a whole, are more than an ancillary or incidental allocation of risk, and are more than a small element of the contract that in many other financing transactions is taken by insurance companies. Therefore, by its own terms the LDW is a full blown contractual scheme that contemplates all of the significant risk allocation activities found in what is commonly understood as insurance.

AFG, therefore is involved in more than the traditional business of financing used automobiles. AFG is not the seller of vehicles but rather the purchaser of installment sales contracts for used automobiles from automobile dealers. Accordingly, the LDW must be considered as a whole in relation to AFG's financing business purpose. The installment sales agreement provides that AFG retains a security interest (lien) in the vehicle *and* that the consumer *must* have physical damage insurance covering loss or damage to the vehicle for the term of the agreement and in an amount sufficient to cover AFG's security interest. Consumers are free to obtain the same type of *insurance coverage* in the open market on their own. Although they are under no obligation to purchase LDW *from* AFG, the consumer understands that in order to finance a car with AFG there *must* be some physical damage coverage to protect AFG's security interest. This is a standard provision in automobile financing contracts. Here, the installment sales contract provides that where the customer does not have insurance, AFG will, if it chooses, buy physical damage insurance to protect its interest in the vehicle, and that if AFG chooses to buy insurance the insurance premium is added to the amount financed as shown in the contract. The installment sales contracts further states that if the vehicle is lost or damaged, the customer agrees that AFG may use any insurance settlement to *reduce what you owe or repair the vehicle*.

In instances where the consumer provides proof of insurance coverage, the principal object and purpose of the transaction, the element that gives the transaction its distinctive character is *only* the financing of used automobiles. However, where the consumer "elects" the LDW coverage, the LDW become more than peripheral to that primary object. This is because by electing this LDW as an option, available to consumers for additional consideration, AFG undertakes to assume the risk of damage to the automobile. Thus, after the consumer pays the required fee AFG waives the requirement for the consumer to obtain *separate* insurance that protects *its security interest.* AFG thereby becomes, in effect, the insurer since risk of loss is, per the LDW, shifted from the borrower to AFG. As AFG has assumed the risk of damage, it has the option of either repairing the car to protect its own investment or declaring the car a total loss and canceling the debt. Where repairs are made, money is paid to the repair facilities by AFG pursuant to its contract with the consumer. Under these circumstances the LDW is more than incidental or ancillary to the overall transaction of making a car loan. This is because, from the consumer/borrower's point of view he has agreed to financing terms *and* to an option under which AFG provides the liability insurance for loss or damage to the vehicle, albeit, up to the amount of the outstanding loan balance.

Application of *Truta*

Whether the LDW is distinguishable from the collision damage waiver considered in *Truta* is key to analyzing this case. The Department argues that LDW is different from *Truta's* collision damage waiver because AFG has a security interest in the vehicle, the bargaining positions of the parties are unequal, AFG's fees are too high, consumers are required to pay a $500 deductible before the risk transfer provisions become operative and AFG makes payments to third party repair facilities.[5]
These arguments will be considered in order.

Whether AFG has an ownership or security interest in the vehicles makes no difference. The goal in either case is to shift the risk of damage to the lessor/lender. Under the retail installment contract here, or the rental agreement in *Truta*, the consumer takes possession of the vehicle on the condition that the consumer protects the interest of the lessor/lender by paying for, or insuring against, any loss. Under the LDW, AFG *assumes* for a fee the insurance requirement and the risk of loss is shifted to AFG. Under *Truta's* collision damage waiver the risk of loss shifted from the consumer to Avis for a $6.00 daily fee.

The relative bargaining position of the parties in *Truta* and in this case, however, is different. The Statement of Stipulated Facts and the *Truta* opinion are silent on this issue. What is known is that the consumers in *Truta* have choices and that their participation is voluntary. Here, the consumer does not have an option at all; he must have physical damage coverage whether it is from a third party insurance company or from AFG. Without any liability coverage, no loan is made. In Truta the consumer the option was voluntary. Here, consumers may choose whether or not to finance a vehicle and they may do so through a financing company of their choice. But when they choose to finance the automobile through AFG liability insurance coverage is mandatory, not as in *Truta*, voluntary. A standard provision in automobile financing contracts is that the consumer obtains physical damage coverage. AFG requires this; the consumer's choice, therefore, is only as to who provides the coverage. The consumer may obtain physical damage insurance from any number of insurance carriers, but by offering LDW, AFG

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[5] In distinguishing *Truta*, the Department notes that Respondents do not own the vehicles, that the fee in *Truta* was small compared to the loss shifted, that the fee in this matter can amount to over 80 percent of the financed value, that the burden falls heavily on the borrower who may have little if any bargaining power in the transaction and that there is clearly indemnity contemplated in the payments made to automobile repair facilities as well as debt relief to the borrower.

clearly promotes itself as the alternative insurer. Therefore, for a fee AFG will provide for physical damage insurance *and* debt cancellation insurance. While it is true that a consumer may, after 30 days of the contract, opt out of LDW, he must nevertheless obtain physical damage insurance coverage on the vehicle naming AFG as the loss payee. Only then will the LDW terminate and the monthly payment for the LDW will cease. Here, unlike in *Truta* where the option was voluntary, physical damage coverage is mandatory.

For some consumers, because of poor driving records or low income, they may be unable to obtain or afford physical damage insurance coverage. The LDW allows them to finance a car where they would not otherwise have been able. Utilization of LDW in such cases is indicative of unequal bargaining position. The Department argues that because LDW is utilized in almost half of AFG's auto financing transactions it must stand shoulder to shoulder with its financing business. For many of these consumers, therefore, the LDW is a "deal maker". As such, LDW *is a major* component of the commercial transaction, and is more than ancillary to the vehicle financing agreement. In fact, without <u>any</u> liability insurance coverage there is no deal. By promoting itself as an alternative source for the LDW, AFG has changed the contract to <u>more</u> than just a financing agreement. LDW is, therefore, part and parcel of the principal object and purpose of the automobile financing transaction: the safeguard of its security interest in the vehicle. Accordingly, the LDW contract plan *as a whole* is more than a "bit" of an insurance contract.

The Department contends that the fees charged by AFG are substantial and not a small element of insurance that assesses the borrower a reasonable fee for protection. As an example the Department notes that the LDW fee for a $2,000 loan financed over 72 months is $1,728, or 86 percent of the loan amount. This is somewhat misleading because 61 percent of AFG's installment sales contracts have a term of 36 months or less and the average cost of the LDW is approximately $1,300 over a two-year term or $55 per month. The daily fee for Avis's collision damage waiver in *Truta* was $6 per day for allocating a risk of $1,000. This amounts to $180 over a 30-day month. The amount of risk assumed by AFG is also higher than Avis, the lowest amount financed being $2,000. It does appear that the LDW fees are much less than the collision damage waiver fee considered in *Truta.*

When a vehicle is damaged and AFG elects to pay for repairs, the consumer is required to pay a $500 deductible before the risk transfer provisions of the LDW become operative. In *Truta* there was no such requirement. The Department argues, therefore that the deductible requirement creates an insurance relationship. Respondents' argument that the deductible only affects the amount of risk that AFG assumes and is part of the risk allocation is not controlling. AFG could have charged a higher LDW fee in lieu of requiring the consumer to pay a deductible. Insurance cases reviewed do not mention the deductible as a factor in the analysis of what defines insurance. Nevertheless the deductible is a factor to consider since they are certainly associated with insurance contracts. Therefore, the presence of deductible provisions alone while an important or even relevant factor in determining whether a contract is one of insurance is not determinative of the issue of whether the LDW, in effect, contains a major insurance contract component.

The Department further suggests that *Truta* is distinguishable because no payment or indemnity was contemplated to any third party in that case. It believes that LDW is grounded in indemnity because it contemplates payments to third party automobile repair facilities. In *Truta*, Avis simply assumed the risk of damage to the car and would either repair the car or write it off as a total loss. It is different here. Under the LDW, AFG agrees to forgive the balance of the consumer's debt if the vehicle is declared a total loss to collision or theft, *and* to pay the costs of repair, less a $500.00 deductible, where the repair cost does not exceed the value of the car.

Here the contract provisions clearly contemplate payments to repair shops for costs of repairs to the vehicle. AFG has the discretion to have the car repaired at a repair shop of its choice. No cash payments are made to consumers. AFG directly pays repair costs to contracted body shops. Such payments to independent automobile repair shops a do not alone make the LDW insurance, but is a factor to consider as to whether LDW contains a major insurance component. Payment to third parties may only be relevant when injured third parties are being indemnified as a result of a party's negligence. (*Hertz Corporation* v. *Home Insurance Company* (1993) 14 Cal.App.4th 1071, 1075.) In such cases there is a public interest in regulating the lessor to protect the injured third party. But the public is interest is also served here in regulating the repair insurance component in the LDW contract by requiring that AFG have sufficient funds to pay the costs of repairs to the consumer's automobile.

Thus, the AFG assumption of the costs of repairs from its own account *is* the liability component in the LDW. The fact that in *Hertz*, the liability to third parties resulted from an accident which occurred while the rented vehicle merely distinguishes the facts in the cases, not the principle that the LDW has also has a major liability component, which contractually obligates AFG to pay the repair costs to a third party repair shop. While it is true that the assumed risk in this case extends only to physical (collision) damage to the vehicle, and that there is no agreement to indemnify injured third parties, they makes no difference in our analysis of whether AFG's LDW constitutes the transacting of insurance. As in *Truta*, AFG agrees to not to hold the lessee/borrower liable for physical damage to the vehicle, subject to the payment of a $500.00 deductible where the cost of repairs does not exceed AFG's lien interest or is not economically feasible.

Truta, therefore, is to a great extent distinguishable from the facts here, and, accordingly is not as controlling as alleged by Respondents.

Public Policy Considerations

The Department believes that compelling policy reasons support a finding that LDW is a policy of insurance. The Department endorses and urges an approach that supplements traditional insurance analysis with a "regulatory value test." (See Holmes's Appleman on Insurance, 2d, *op cit. supra,* § 1.4(C).) Under this approach it is proposed that courts also determine "if the discrete transaction ought to be regulated in the public interest as the business of insurance." (*Id*. at pp. 37–38.) Appleman reasons that "[p]rotection of the public from the schemes, deceptions and insolvencies of third parties who make insurance-type promises is another solid reason to justify the application of state insurance regulatory laws." (*Id*. at p. 39.)

No California court has adopted all elements of Appleman's supplemental test into the analysis of what constitutes insurance and thus it is not binding.[6] However, traditional insurance analysis has considered the value of the interests being protected in the transaction in relation to the purposes and policies of state insurance regulatory laws. The California Supreme Court has acknowledged: "It is no longer open to question that the business of insurance is affected with a public interest." (*Carpenter* v. *Pacific Mut. Life Ins. Co.* (1937) 10 Cal.2d 307, 329.) Similarly the United States Supreme Court has observed "government has always had a special relation to insurance. The ways of safeguarding against the untoward manifestations of nature and other vicissitudes of life have long been withdrawn from the benefits and caprices of free competition." (*Osborn* v. *Ozlin* (1940) 310 U.S. 53.)

Most measures of insurance regulation are targeted at one of three main objectives: 1) to assure solidity and solvency of insurers, 2) to avoid overreaching by

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[6] Appleman suggests that courts should minimally make the following inquiries:

(1) What is the private interest sought to be protected in the commercial transaction? [Matters, such as insurable interest and risk of harm to that interest, under traditional definitions are evaluated here.]
(2) Who is the party assuming the risk transferred? Is the protected interest indigenous to that party? [Arguably, there is more need for regulation if the assuming party is an independent, for-profit entity promising indemnity against certain risks to the insurable interest.]
(3) Is the protected interest indigenous to the state and all its citizens? [Manifestly, a state and its citizens have a common indigenous interest in safety and health, including the delivery and quality of medical care, safe cars, well-built homes, and the like. Other interests may not be indigenous.]
(4) Does the value of the indigenous interest invoke the purposes and policies of state insurance regulation for all its citizens? [Many reasons justify state insurance regulation, for example: to assure solvency, to assure fairness in rates and rating classifications, and to prevent contractual over-reaching. These concerns are addressed in this final question.]

(Holmes's Appleman on Insurance, 2d, *op cit. supra*, § 1.4(C), pp. 39-40.)

insurers, and 3) to assure that rating classifications and rates are reasonable and fair. (Keeton, Basic Text on Insurance Law (1971) § 8.3, pp. 554-55.) The provisions of the California Insurance Code recognize the public interest involved and provide for rehabilitation of insurance companies. (*Carpenter* v. *Pacific Mut. Life Ins. Co.*, *supra*, 10 Cal.2d at p. 330.) Matters over which the Insurance Commissioner currently has oversight include paid in capital requirements, acceptable loss ratios, acceptable rates, rate changes, unfair practices, fair claims settlement practices and agent-broker conduct and discipline. All derive from the public's interest in regulating such matters.

The primary and traditional concern behind state regulation of insurance is to assure solvency – sometimes called "solidity" – of insurance companies. (Holmes's Appleman on Insurance, 2d, § 3.7, p. 385.) "The principle of *solidity* is pervasive; it inheres in almost every corner of the regulator's field of activity." (Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law*, (1960) 45 Minn. L.Rev. 471, 480.) Justice Brennan noted in his concurring opinion in *SEC* v. *Variable Annuity Life Ins. Co. of America* (1959) 359 U.S. 65 at 90-91, "The prevention of insolvency and the maintenance of 'sound' financial condition in terms of fixed-dollar obligations is precisely what traditional state regulation [of insurance] is aimed at."

The California Supreme Court looked to the purposes and nature of the regulatory provisions arising under the Insurance Code in *California Physicians' Service* v. *Garrison*, *supra*, 28 Cal.2d at p. 810, particularly those relating to the maintenance of reserves and to the regulation of investments and financial operations. The court observed that the extensive insurance regulations are designed to protect the insured, or the public, from the insurer and noted:

> Such regulations become important only if the insurer has assumed definite obligations. Conversely, it is evident that they are not intended to apply where no risk is assumed and no default can exist. (*Ibid*.)

The *Garrison* court explained how by the very nature of <u>its plan operations</u> the California Physicians' Service could not accumulate vast reserves and how the flow of funds from patient to physician was on a monthly pay-as-you-go basis and to require reserves would be a useless and uneconomic waste.

The *Truta* court engaged in a similar public interest analysis, giving deference to and citing the Department's analysis of the rental car situation. (*Truta* v. *Avis Rent A Car System, Inc.*, *supra,* 193 Cal.App.3d at p. 815.) The court agreed that no interest of the public would be protected by the Department assuming jurisdiction because the lessor was not agreeing to pay anybody anything. Rather, the lessor simply agreed not to hold the lessee liable and there was no need for accumulating reserves. In short, the solvency or insolvency of the lessor there did not affect the collision damage waiver provision in the contract. (*Ibid*.)

Respondents contend that the state has no interest in regulating what is essentially a debt cancellation contract because it makes no difference to the consumer if the lender is solvent. They note that if AFG became insolvent and the borrower with an LDW were involved in a collision, the position of the borrower would not be affected because his debt would simply disappear. But here the insolvency of AFG would harm the owner/borrower in instances where the damage to the automobile is not a total loss or theft, such as where the owner/borrower has made improvements to the automobile; and where it is economically feasible to make the repairs. In these instances, unlike in *Truta*, the LDW should trigger the State's interest in regulating the finances of AFG.

Respondents rely largely on *First National Bank of Eastern Arkansas* v. *Taylor* (8th Cir. 1990) 907 F.2d 775, where the Eight Circuit Court of Appeals held that a debt cancellation contract issued by a bank was not an insurance contract subject to regulation by the Arkansas Department of Insurance. The court reasoned that debt cancellation contracts are incidental to a bank's lending power and are not the business of insurance because the transactions differ significantly from traditional insurance contracts. The *Taylor* court based its analysis on preemption principles contained in the McCarran-Ferguson Act. (15 U.S.C. § 1012.) The precise issue in *Taylor* was whether debt cancellation contracts constituted "the business of insurance" under the McCarren Act and were thereby subject to state regulation. State law is not controlling on the issue of whether an activity falls within the "business of insurance" as that term is used in the McCarren Act and for that reason the Department contends that Respondent's reliance upon *Taylor* is misplaced.

Taylor was decided on preemption grounds, the court's analysis of how debt cancellation contracts compare to traditional insurance contracts is useful here, but only if the LDW as a whole is a debt cancellation agreement[7], which as discussed above, it clearly is not. In *Taylor* the bank offered debt cancellation contracts as *an option* to customers borrowing $10,000 or less. These contracts obligated First National Bank of Eastern Arkansas *to cancel* the unpaid loan balance upon the borrower's death and nothing more. The Arkansas Department of Insurance believed that these debt cancellation contracts were the equivalent of credit life insurance policies subject to state insurance laws and ordered the bank to cease offering the contracts.

While the *Taylor* court recognized that debt cancellation contracts transfer some risk from the borrower to the bank the contracts did not require the bank to take an investment risk or to make payment to the borrower's estate. (*First National Bank of*

[7] There appears to be a question as to whether the LDW is a debt cancellation agreement of the type involved in *Taylor*. By the terms of the LDW, even under a total loss or theft, LDW requires that the consumer pay a $500.00 fee, which, presumably, must this fee be paid before AFG cancels the remaining loan balance due. If the $500.00 fee is not paid, it follows that the consumer continues to be liable for the debt.

Eastern Arkansas v. *Taylor*, *supra*, 907 F.2d at p. 780.) The debt was simply extinguished when the borrower died and therefore "the primary and traditional concern behind state insurance regulation – the prevention of insolvency – is not of concern to a borrower who opts for a debt cancellation contract." *(Ibid.)* Here, however, the LDW provides for *more* than debt cancellation since it contains a major repair component.

The courts in both *Truta* and *Taylor* acknowledged that collision damage waivers and debt cancellation contracts shift the risk of loss and have other aspects similar to insurance contracts. Even so, these courts found that the state had no interest in regulating such contracts. In those cases, it made no difference to the consumer of a debt cancellation contract if the lender became insolvent, and the solvency or insolvency of the lessor did not affect the collision damage waiver provision in car rental agreements or to the loan. The debt or obligation would simply disappear.

But it is different here. The LDW is distinguishable from the collision damage waiver in *Truta* and the debt cancellation contract in *Taylor*. If AFG became insolvent and the consumer was involved in a <u>minor</u> collision, the consumer's debt would disappear, but so would his interest in an automobile that would be repaired but for AFG's insolvency. This would be true even where the consumer meets the condition precedent of paying the $500.00 deductible in order to have his automobile repaired. As in *Truta*, AFG is not simply agreeing to not hold the consumer liable for total loss or theft; it also agrees to make the repairs where it is economically feasible and where the consumer pays the $500.00 deductible. In this instance there is a need for accumulating reserves. The solvency or insolvency of AFG therefor does affect the consumer's expectations that his vehicle will be repaired where it the vehicle has sustained damages of more than $500.00.

Respondents' response to this argument, of course, is that under the contract it, and it alone, has the discretion as to decide whether the vehicle should be repaired, and therefore there is no need for as the court held in *Garrison* to require reserves because to do so would be a useless and uneconomic waste. By extension, this means that even where the vehicle has sustained minor damage and AFG is on the brink of insolvency, AFG has the sole and unlimited discretion to declare the vehicle a total loss, thereby circumventing the consumer's expectation that his vehicle will be repaired, subject to payment of $500.00. Unlike in *Garrison*, the LDW repair provision is not a pay-as-you go plan. Thus, AFG's exercise of its discretion to not repair the vehicle if repair costs may lead it to insolvency would be a violation of its contract since AFG would not be acting in good faith under the contract. In such a situation the consumer's interest in having the repairs made would not be protected. Under California law, "all contracts contain an implied covenant of good faith and fair dealing [that] "requires each contracting party to refrain from doing anything to injure the right of the other to receive the benefits of the agreement,' " San Jose Prod. Credit Assign v. Old Republic Life Ins. Co., 723 F.2d 700, 703 (9th Cirri. 1984) (quoting Egad v. Mutual of Omaha Ins. Co., 620 P.2d 141, 145 (Cal. 1979)). If Respondents have their way the consumer's interest in having the vehicle repaired is not protected. The Insurance Department would protect that interest by requiring AFG to maintain adequate reserves to cover contingent repair expenses under the LDW repair provisions. The Department can do so since the LDW, as a whole, is an insurance contract, and therefore, subject to the Department's regulatory powers.

By reason of all of the above it is determined that the primary and traditional concern behind state insurance regulation – the prevention of insolvency – is a concern here. The public interest would be served by having the Department of Insurance regulate AFG as it would other insurance companies for purposes of preventing insolvency or otherwise maintaining sound financial conditions.

The Department contends that there are other public policies reasons for regulating LDW transactions. A significant part of the Department's mission is to insure that consumers are dealt with fairly by the insurance industry. Without oversight by the Insurance Commissioner the Department argues that nothing stands between the consumer and unfair rates, unacceptable loss ratios, unfair practices, unfair claims settlement practices, inappropriate agent-broker conduct and other consumer protection issues.

Accordingly, the Department has the authority to regulate AFG's LDW total loss and repair program because, as a whole, the contract plan is one of insurance. The fact that AFG is regulated for financial stability by the California Department of Corporations and that it is required, as a consumer finance lender to obtain a license and to file an annual financial report with the Department of Corporations makes no difference. Nor does the fact that The Department of Corporations has examination authority over AFG under Financial Code section 22701.

Under the Insurance Code's statutory scheme the LDW is very similar in form to credit or credit life insurance but doesn't precisely fit within either definition. These types of insurance are common forms of decreasing term coverage, in which coverage is for the duration of the term of the note or mortgage and the amount payable in the event of death of the insured is the amount of debt outstanding at that time. Conceptually, credit life and disability insurance is identical in to the LDW program with the exception that the contingency that triggers the payoff of the debt is the death of the borrower rather than the damage to or theft of the vehicle. (Insurance Code section 779.2, Penn Sec. Life Ins. v. Rising (1976) 62 Cal.App.3d 302) Credit insurance is insurance of persons engaged in business against loss by reason of extending credit to those dealing with them. (Insurance Code section 113) In both cases the outstanding balance of the debt is paid upon the happening of the contingent event and in both cases the obligation of the insurer to the insured is extinguished when the debt is retired, except that here LDW has a major repair component. Of further note is the fact that here and in credit life and disability insurance the protection accrues to either the insured (or the estate) and the creditor.

The LDW program certainly falls within the definition of miscellaneous insurance found at Insurance Code section 120 which includes, " . . . any insurance not included in any of the foregoing classes [Insurance code §§101-119], and which is a proper subject of insurance." The AFG's LCW total loss and repair program clearly falls within the miscellaneous category found at section 120 because it is a proper subject of insurance.

LEGAL CONCLUSION

The LDW program constitutes the unlawful transaction of insurance in California. The LDW total loss (debt cancellation) and repair plan program are major component of AFG's automobile financing business given that no financing is made without *any* liability insurance. Thus, the LDW as a whole is a dominant element of the transaction, automobile financing, and as such it conclusively demonstrates that the transaction is within the reach of insurance regulatory laws. It is also determined that the primary and traditional concern behind state insurance regulation— the prevention of insolvency—is a concern here since the solvency or insolvency of AFG affects the consumer's expectations under the LDW repair provision.

Accordingly, AFG's LDW program as a whole falls under the Insurance Commissioner's regulatory jurisdiction.

ORDER

The April 25, 2001 Order to Show Cause issued by the Department of Insurance is sustained.

DATED: May , 2002

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